June 10, 2010

MEMORANDUM

TO: Representative Luciano "Lucky" Varela, LFC Chair
Legislative Finance Committee Members

FROM: Dan White, LFC Financial Economist
Michelle Aubel, LFC Fiscal Analyst II

SUBJECT: LFC Report of Investment Performance – FY2010 Third Quarter

Investment Performance Highlights:

- All state investment agencies were able to achieve quarterly returns in excess of internal benchmarks during the third quarter of FY10. However, only the Land Grant Permanent Fund (LGPF) and the Educational Retirement Board (ERB) were able to outperform five-year benchmarks.

- The State Investment Council (SIC) managed Land Grant and Severance Tax Permanent Funds (LGPF and STPF) outperformed internal benchmarks in the third quarter of FY10 by 60 basis points (bps[1]) and 40 bps respectively. While the last two quarters of outperformance by each fund are extremely encouraging, both funds' one-year performances are still significantly lower than benchmarks.

- PERA continued its outperformance for the third quarter, beating its internal benchmark by 98 bps and ranking in the 9th percentile. The fund is still significantly trailing long-term benchmarks, including its five-year benchmark by 148 bps.

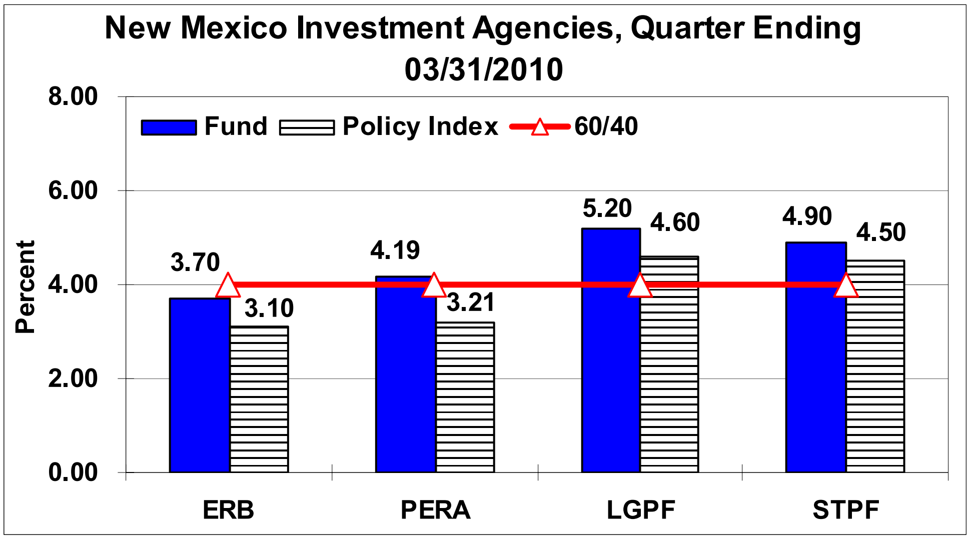
- Although slipping in its peer ranking for the quarter, ERB outperformed its policy benchmark for the fourth consecutive quarter, this time by 60 bps. More importantly, the fund continues to surpass its one-year and five-year benchmarks as well, making it the only New Mexico fund beating its quarterly, one-year, and five-year benchmarks. Additionally, manager performance has added a staggering 670 bps of value for the 12 months ending March 31st.

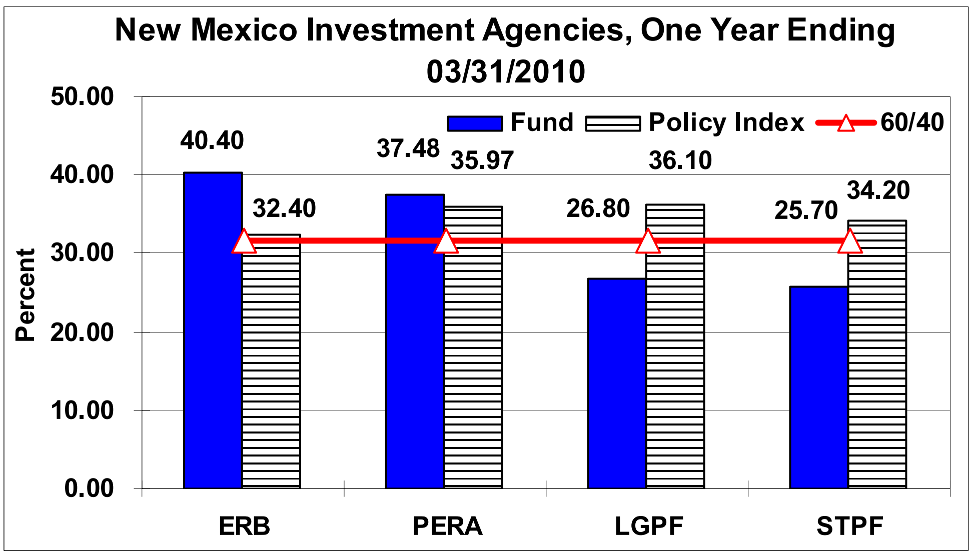
- Peer rankings continued to improve for PERA and SIC in the quarterly to one-year range, but the five-year rankings remain extremely low. The 10-year rankings remain low for all agencies (see page 4).

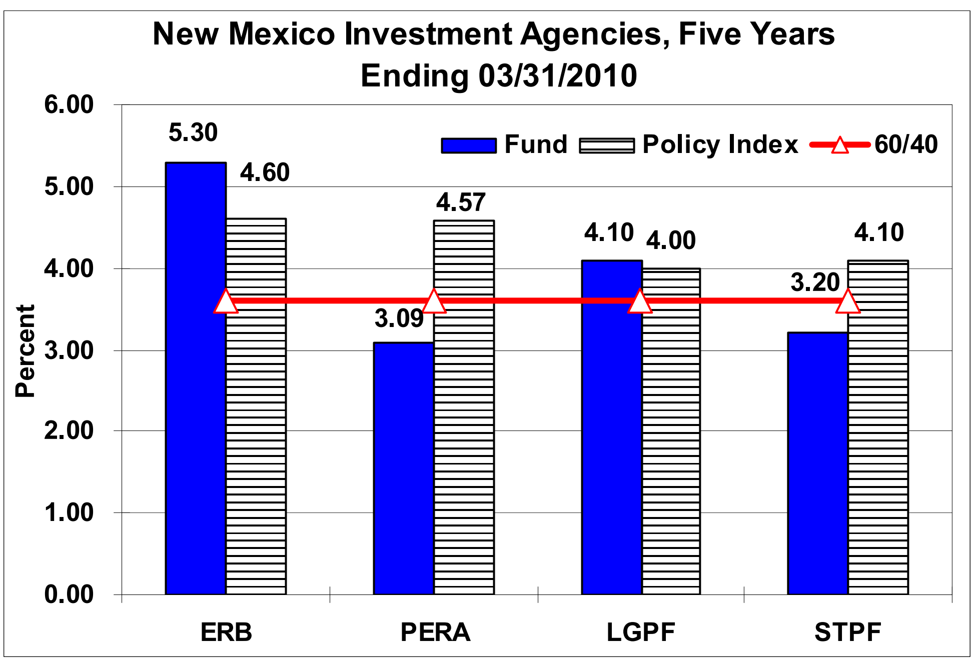
- This quarter's special focus section discusses the appropriateness of investment agency annualized return targets for actuarial and distribution purposes.

[1] Basis Points (bps) represent a hundredth of one percent. For example, if the LGPF has underperformed its quarterly benchmark by 170 bps, then it has underperformed by 1.7%.

OVERALL FUND PERFORMANCES vs. RELATIVE BENCHMARKS







FUND ASSET VALUES

Total asset values for all funds rebounded by nearly $1.2 billion in the third quarter of FY10. All funds saw quarterly asset increases in excess of three percent, with the LGPF increasing by 4.7 percent. Over the past twelve months total combined asset values have seen a substantial rebound of nearly 30 percent or $7.47 billion. Despite such improvement, total combined asset values remain nearly $6 billion below FY08 highs. Reported asset values reflect contributions and distributions in addition to investment returns.

Current Asset Values (millions)
For Quarter and Year Ending March 31, 2010

Quarterly	ERB	PERA*	LGPF	STPF	TOTAL
Current Asset Values (3/31/10)	$ 8,554	$ 10,947	$ 9,496	$ 3,670	$ 32,667
Value Change (Previous Quarter)	275	351	423	121	1,170
Percent Change	3.3%	3.3%	4.7%	3.4%	3.7%

Annual	ERB	PERA*	LGPF	STPF	TOTAL
Ending Asset Values (3/31/10)	$ 8,554	$ 10,947	$ 9,496	$ 3,670	$ 32,667
Value Change (Year Ago)	2,346.3	2,760.4	1,771.7	595.6	7,474.0
Percent Change	37.8%	33.7%	22.9%	19.4%	29.7%

*Excludes assets held at STO

ACTUAL VS. TARGET ASSET ALLOCATIONS

All agencies' actual asset allocations remained relatively close to target levels, with a few minor exceptions. The STPF differed the most significantly of all agencies, particularly relative to its fixed income and alternative asset allocations. However, the SIC has recently made changes to the allocation policies of both permanent funds, which should rebalance accordingly. ERB has substantially reduced its public equity allocation as it implements a new long-term allocation policy, from 67.6 percent to 45.5 percent. It now has the lowest commitment to equities of all funds.

Fund Asset Allocation Detail, Quarter Ending March 31, 2010

	ERB*		PERA		LGPF		STPF	
	Actual	Target**	Actual	Target**	Actual	Target	Actual	Target
US Equity	**26.9%**	**25.0%**	**37.4%**	**35.0%**	**51.8%**	**51.0%**	**51.2%**	**48.0%**
International Equity	**19.0%**	**20.0%**	**25.1%**	**25.0%**	**8.9%**	**10.0%**	**11.2%**	**10.0%**
Fixed Income	**32.4%**	**33.0%**	**23.4%**	**25.0%**	**17.6%**	**15.0%**	**4.9%**	**11.0%**
Total Alternatives	**14.4%**	**17.0%**	**13.8%**	**15.0%**	**21.4%**	**24.0%**	**31.8%**	**31.0%**
Private Equity	2.9%	2.0%	2.1%	2.5%	8.8%	6.0%	15.3%	12.0%
Real Estate/Real Assets	5.5%	5.0%	4.2%	5.0%	3.4%	3.0%	4.4%	3.0%
Absolute Return	6.0%	10.0%	7.5%	7.5%	9.2%	15.0%	8.0%	15.0%
ETI	N/A	0.0%	N/A	0.0%	0.0%	0.0%	4.1%	1.0%
Global Asset Allocation	**4.8%**	**5.0%**	**N/A**	**0.0%**	**N/A**	**0.0%**	**N/A**	**0.0%**
Cash Equivalents	**2.6%**	**0.0%**	**0.4%**	**0.0%**	**0.3%**	**0.0%**	**1.1%**	**0.0%**
Total Fund %	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

**ERB is is adopting a new asset allocation mix that will raise its commitment to alternatives to 35% and correspondingly reduce equity and fixed income asset classes.*

***Due to the long implementation period for some alternatives, both PERA and ERB have adopted interim targets.*

LONG-TERM PERFORMANCE RELATIVE TO PEERS

Peer Percentile Rankings*

	1 Year	5 Year	10 Year
ERB	9	11	87
PERA	13	96	74
LGPF	64	75	77
STPF	68	85	86

* Percentile rankings (1 is highest) for ERB and PERA relative to U.S. Public Funds. Permanent Funds ranked relative to U.S. Endowment Funds.

PERA has joined ERB in the top quartile of U.S. Public Funds from a one-year performance standpoint. This represents a substantial turn-around over the last 12 months, when the fund stood in the 97th quartile. ERB remains the only New Mexico fund to rank higher than 25th for the past five years; all other funds rank well in the last quartile of their peer groups for the five-year period. With the exception of PERA, which ranks 74th, all funds ranked in the last quartile relative to peers for the past ten years.

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

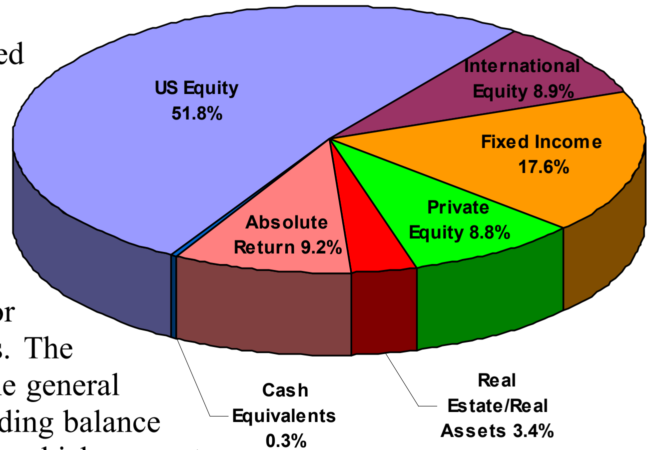
The third quarter of FY10 saw continued growth throughout global financial markets. Such growth, although steady, was more moderate than the first half of the fiscal year. Domestic equity indices, in particular, saw steady growth – with the Standard & Poor's 500 Index gaining 5.4 percent for the quarter. These strong quarterly gains have to some extent restored relative parity to domestic and developed international equity indices. One year returns for the two primary domestic (S&P500) and developed international equity (MSCI EAFE Net) indices stood at 49.8 percent and 54.4 percent, respectively, as of March 31st. However, emerging market indices are still well outpacing both domestic and developed international equity indices over the past 12 months.

Fixed income indices also saw steady growth for the quarter, adding to their already solid annual performances. The Barclay's Aggregate Index added 1.8 percent for the quarter, resulting in gains of 7.7 percent for the past 12 months. High yield indices showed the most strength both for the quarter and year. The Barclay's High Yield Index finished the year with gains in excess of 56.2 percent. With the exception of commodities, all alternative indices showed positive quarterly returns as well. Real Estate Investment Trusts (REITs) continue their impressive rebound from historic lows and have now produced returns in excess of 113 percent for the past twelve months.

Since the end of the third quarter the economy has continued to show early signs of a recovery. Industrial production has continued to show strength, having shown expansion the past 10 consecutive months. Factory orders are also showing steady growth as manufacturers have finally begun to draw down inventories. Construction spending has also shown moderate growth, however job reports throughout the sector continue to be disappointing. The tone of the Federal Open Market Committee (FOMC) appears to be changing slightly as the Kansas City Fed President announced last week that he would like to see some type of rate hike before the end of the summer. President Tom Hoenig stated that enough evidence of an economic recovery now exists to support returning interest rate policy to more normal levels. Although the latest economic data are beginning to somewhat support Hoenig's position, most economists and Fed policy experts don't expect a rate hike until after the November elections.

Land Grant Permanent Fund (LGPF)

LGPF Asset Allocation as of 3/31/2010

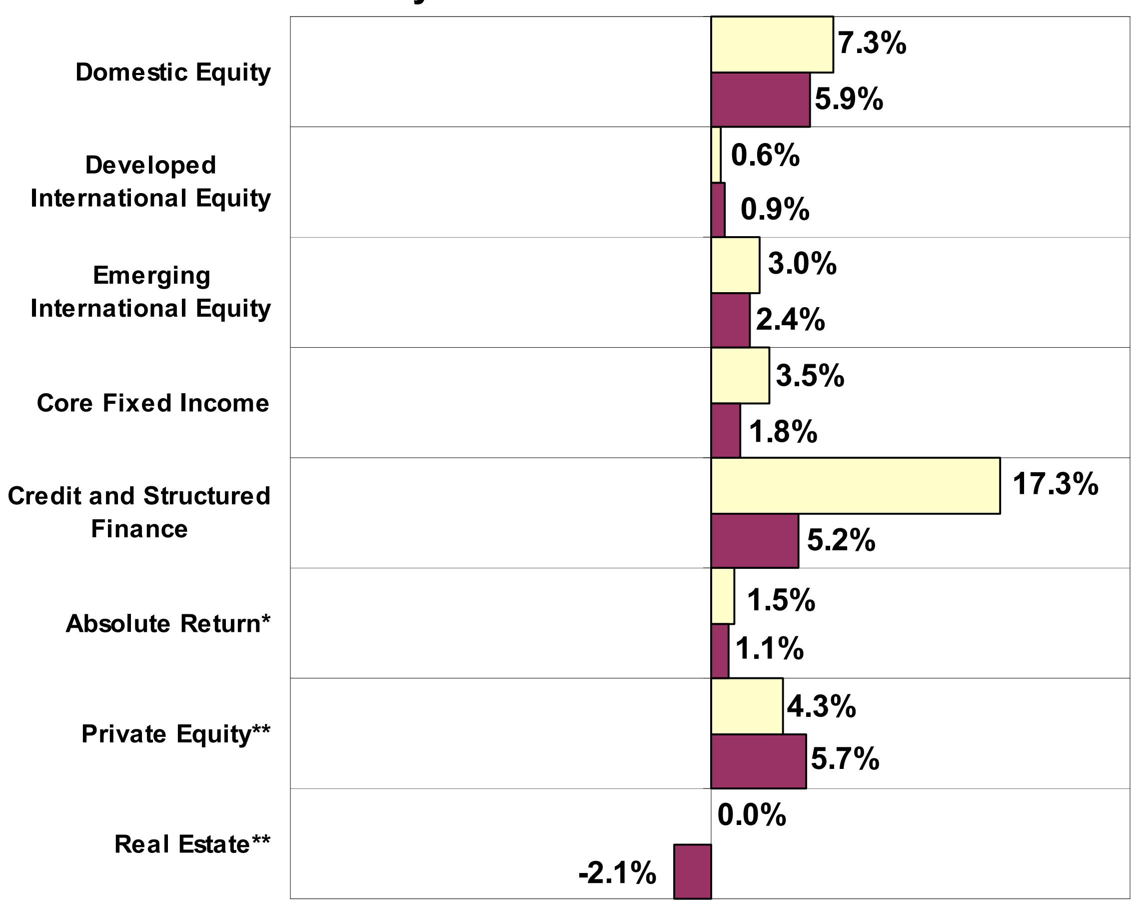


Fund Objective: The LGPF is derived from proceeds of sales of state and federal public lands and royalties from mineral and timber production on state lands. The fund is invested by the state investment officer according to the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund makes annual distributions to the general fund of 5.8 percent of the average ending balance from the previous five calendar years, which support the operations of public schools and various other beneficiaries

Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
5.20%	4.60%	5	26.80%	36.10%	64	4.10%	4.00%	75

LGPF Quarterly Performance vs. Benchmarks

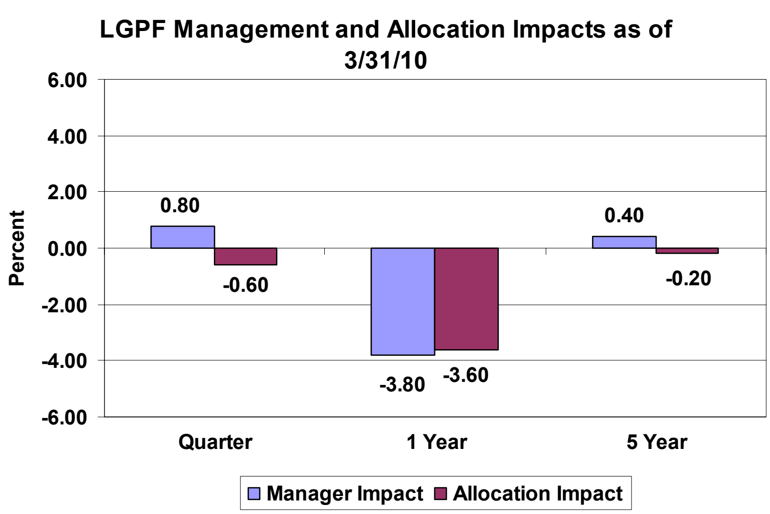


* Results Lagged One Month
** Results Lagged One Quarter

Overview: The LGPF outperformed its quarterly policy benchmark by 60 bps for the second consecutive quarter, ranking the fund in the 5th percentile relative to national peers. This performance is in stark contrast to the preceding two quarters which saw underperformance relative to both benchmarks and peers. Five-year performance has fallen, and is now only slightly better than relative benchmarks. The fund's ten-year return of 2.8 percent is identical to its policy index, but still well below the 8.5 percent used to forecast future distributions to the general fund. The relevance of this benchmark is discussed in more detail in this quarter's special focus section.

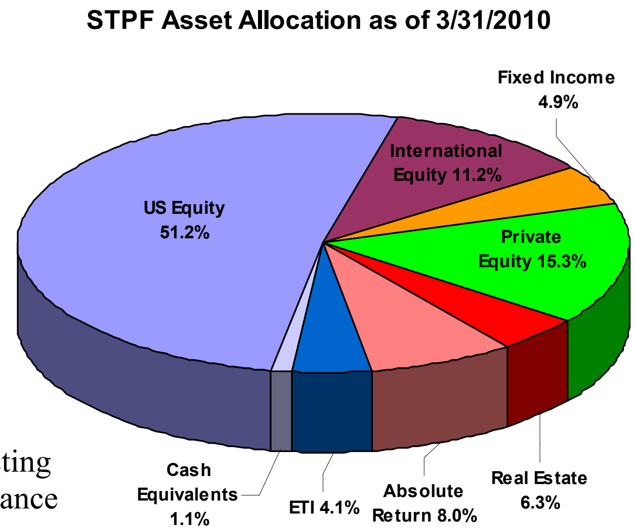
During the third quarter a majority of the fund's asset classes outperformed their relative benchmarks particularly within its traditional asset allocations. Fixed income assets outperformed the most, with credit and structured finance outpacing its benchmark by an impressive 1,210 bps. Although 17.3 percent represents an impressive return from any asset class, such significant outperformance relative to benchmarks within the credit and structured finance pool may be more of an indication of a weak benchmark than manager outperformance. Despite achieving returns of more than 86 percent over the past 12 months, this asset class has struggled for some time and has actually achieved annual returns of negative 18 percent since first being segregated from the rest of the fund's fixed income assets. Domestic equity assets continued to outperform benchmarks despite the discontinuation of the fund's equity hedging program. This is largely due to the SIC's internally managed large-cap portfolio which is currently outperforming benchmarks for every reported time period going back 15 years. In fact the internally managed portfolio has consistently outperformed every large-cap money manager currently employed by the fund. With the exception of absolute return assets, the fund's alternative assets have continued to struggle. Real estate in particular has struggled both in absolute terms and relative to benchmarks. Since inception the fund's real estate portfolio has achieved an annual return of negative 10.2 percent. This compares to a benchmark return of negative 3.4 percent during the same time period.

Management and Allocation Impacts: In the second quarter of FY10, active management gained 80 bps for the fund while asset allocation cost the fund 60 bps. Asset allocation has continued to be a drag on performance as evidenced by the fund's five-year impacts shown below. The fund's target asset allocation was recently amended primarily by decreasing its exposure to public equities which were extremely high relative to national peers. The SIC is currently reassessing the fund's long-term allocation policies.



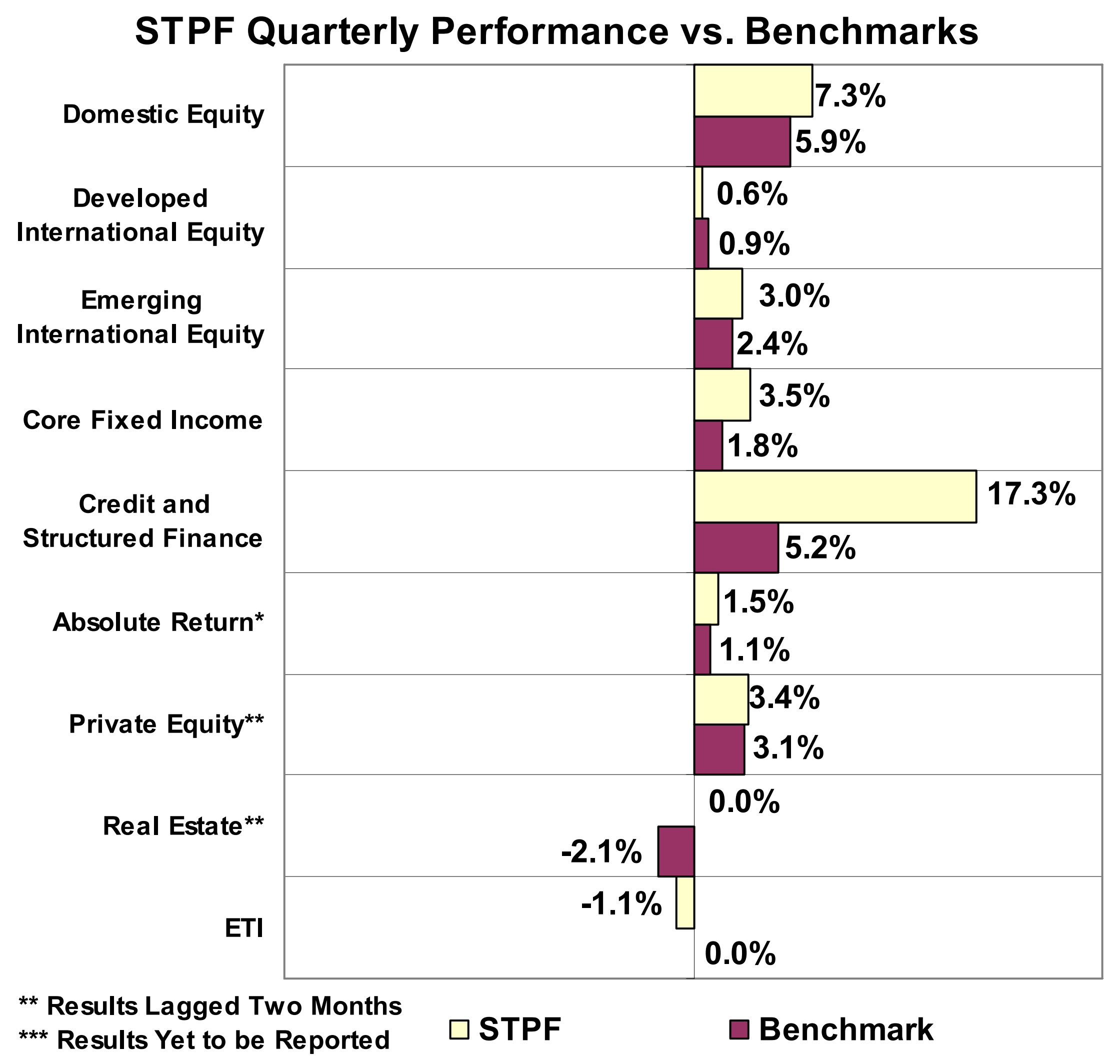
Severance Tax Permanent Fund (STPF)

Fund Objective: The STPF receives contributions from the portion of severance tax proceeds not required for retirement of severance tax bonds. The fund is invested by the state investment officer under the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund currently makes annual general fund distributions consisting of 4.7 percent of the average ending balance from the previous five calendar years.



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
4.90%	4.50%	6	25.70%	34.20%	68	3.20%	4.10%	85

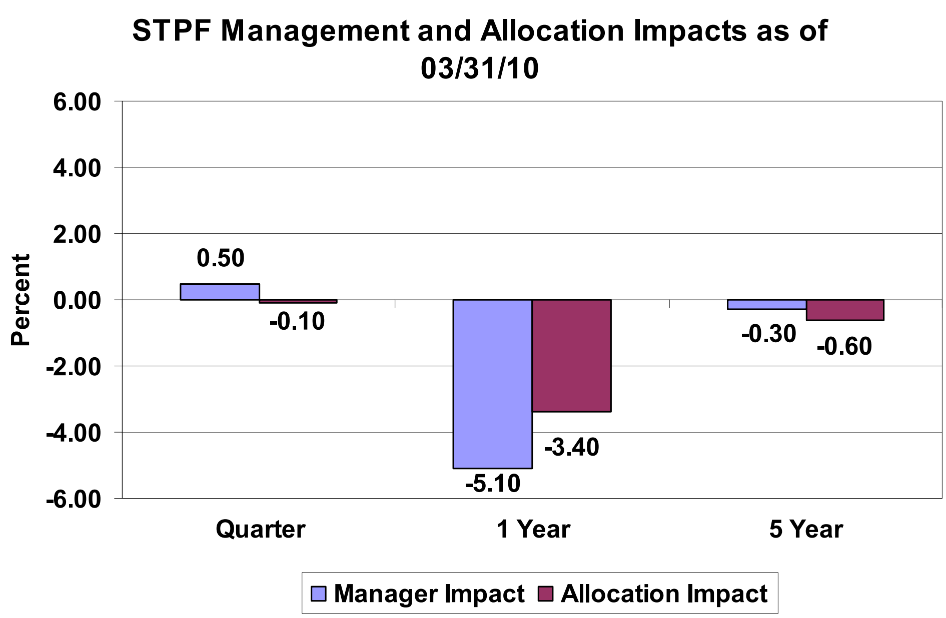


** Results Lagged Two Months
*** Results Yet to be Reported

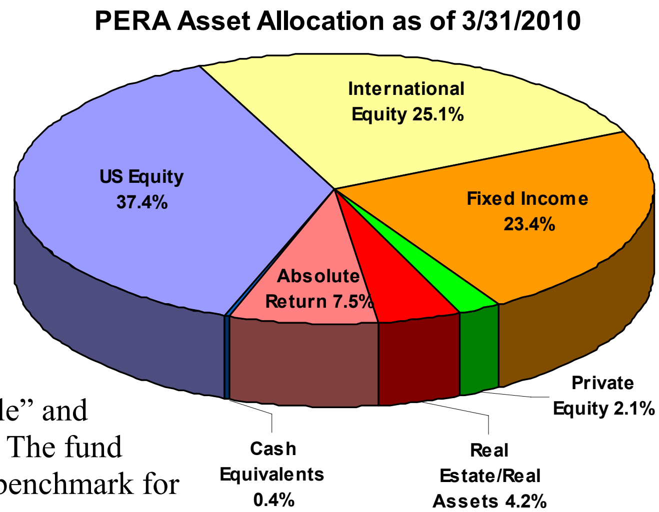
Overview: The STPF continued to improve and outperformed its quarterly policy benchmark by 40 bps, good enough to rank the fund in the 6th percentile versus its peers. The fund's one-year performance while improved is still only good enough to rank it in the 68th percentile versus peers and its five-year performance still ranks in the 85th percentile versus peers. Also the fund's ten-year return of 2.2 percent is still well below all benchmarks including the 8.5 percent used to forecast future distributions to the general fund. As previously mentioned, the relevance of this benchmark is discussed in more detail in this quarter's special focus section.

As always the performance of the STPF was similar to the LGPF with two major exceptions; private equity, and economically targeted investments (ETI). Due to various legislative mandates designed to stimulate economic activity within the state, the STPF typically carries a much higher number of alternative investments in its portfolio, often times as "differential rate investments" which by definition earn less than a market rate. These statutory directives include the zero-interest film loan program, and the New Mexico Private Equity Investment Program (NMPEIP), and a mandatory investment into the New Mexico Small Business Investment Corporation (SBIC). In fact, the only substantial difference between the asset allocations of the two permanent funds is the inclusion of these investments. Thus as a result of these investments, the STPF has consistently underperformed the LGPF for all time-periods. Over the past five years the difference between the two funds' annualized returns has been approximately 90 bps annualized. Because these funds make annual distributions to the state general fund, this means that the decreased performance of 90 bps has a direct negative effect on state general fund revenues. To date no adequate study has been done as to the economic stimulus provided from such programs or whether or not such stimulus outweighs the amount of direct general fund revenue forfeited as a result.

Management and Allocation Impacts: In the second quarter of FY10, active management gained 50 bps for the fund while asset allocation cost the fund 10 bps. The impacts of the investment programs discussed above can be seen clearly in the fund's five-year management and allocation impacts which are 70 bps and 40 bps lower for the STPF than for the LGPF.



Public Employees Retirement Association (PERA)

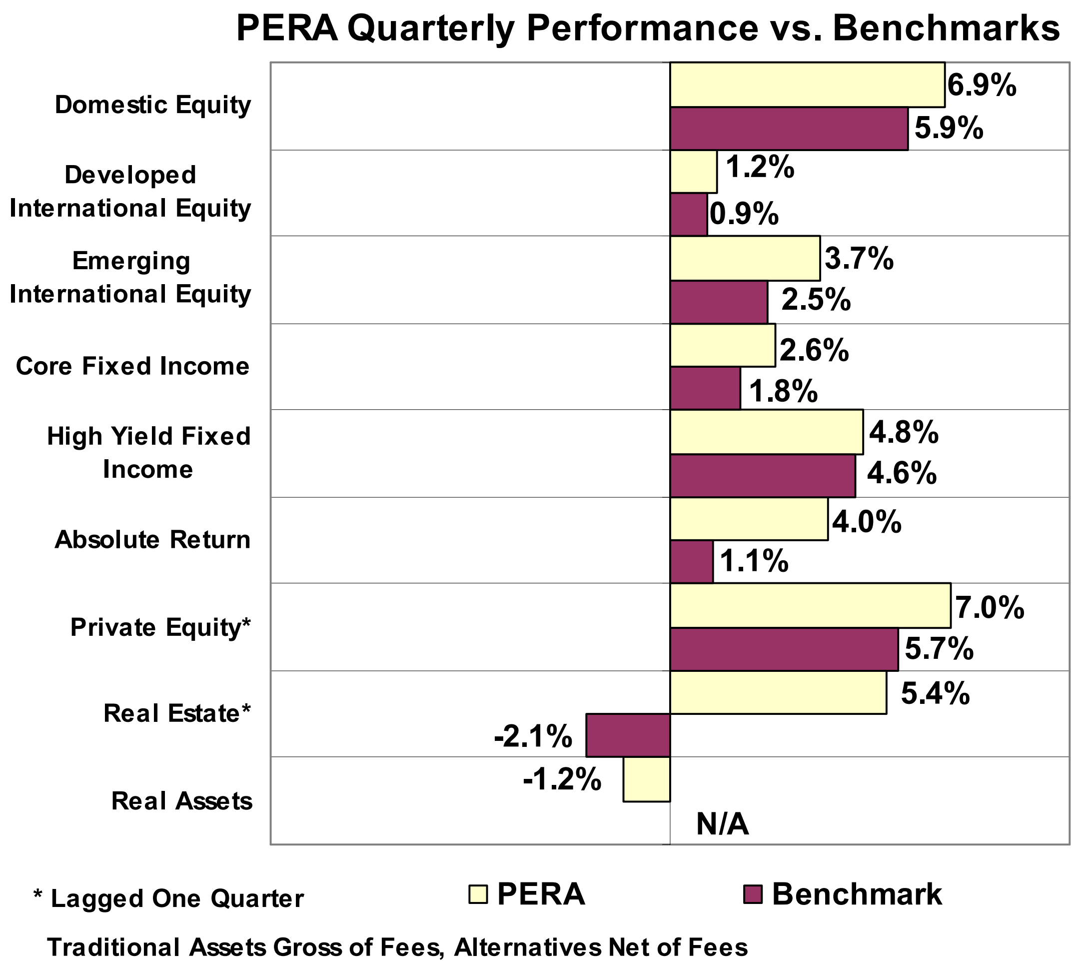


Fund Objective: PERA administers 31 pension plans covering state and local government employees, volunteer firefighters, judges, magistrates and legislators to provide secure retirement. The fund is invested according to the "prudent investor rule" and results are reported in the aggregate. The fund has an 8 percent long-term actuarial benchmark for funding purposes.

Fund Performance vs. Relative Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
37.48%	35.97%	13	3.09%	4.57%	96	3.60%	3.26%	74
Median Fund Performance		32.86%	Median Fund Performance		4.75%	Median Fund Performance		3.99%

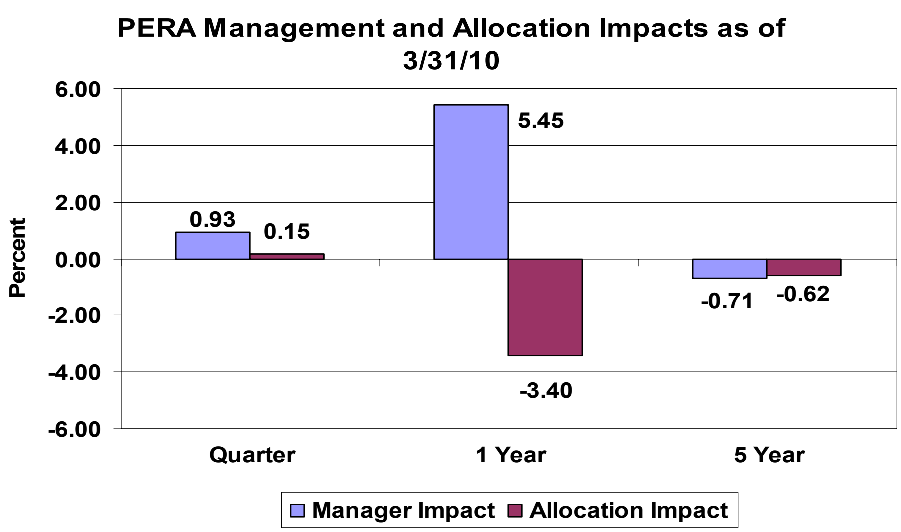
*PERA also has a long-term 8% actuarial benchmark for funding purposes.



Overview: PERA continues its positive performance into the third quarter, beating its interim benchmark by 98 bps and ranking once again in the 9th percentile. The median public fund yielded 3.60 percent for January through March, with a range of 2.37 percent to 4.28 percent. PERA's one-year peer ranking has significantly improved, from the 93rd quartile as of June 30, 2009, to the 13th quartile. However, substantial losses during the 2008-2009 turbulent market continue to drag down the 5-year return, which has improved by about 100 basis points but still remains in the 96th quartile. More importantly, the 10-year return is still under 4 percent, half of the 8 percent the fund's investments must earn to generate sufficient funds to pay benefits. While the 15-year return has improved from 7.48 percent reported at the beginning of the fiscal year to 8.25 percent, cautious optimism is muted by concern over the market rally's sustainability. In the absence of a robust economic recovery, achieving the returns necessary to fully reclaim lost ground is highly uncertain.

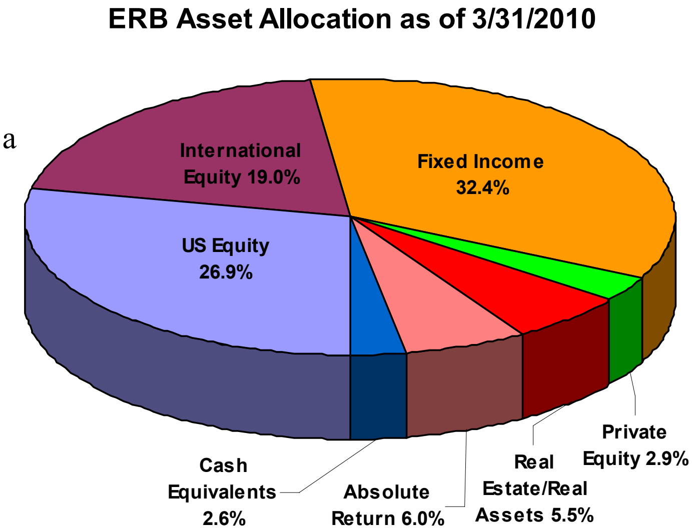
Domestic equity, fixed income, and hedge funds added the most value. Hedge funds, which performed dismally during the market downturn, have performed more in line with expectations during FY10, bringing the inception-to-date annualized return to almost 2 percent compared to -2 percent for PERA's traditional assets over this period. The move to diversify the portfolio from stocks and bonds has benefited the fund even though the initial timing of the program couldn't have been worse. In particular, the most notable contribution to the domestic equity portfolio stems from the portable alpha program, which has posted a 55 percent fiscal year-to-date gain although it still trails its benchmark since inception by -1.69 percent. Cliffwater expects this shortfall to be made up over the next 12 months and the portfolio to ultimately yield 3 percent over its benchmark.

Management and Allocation Impacts: The big story of this quarter is, once again, active management. The fund also received slight contributions from an overweight to domestic equity. Active management added value for each fully funded asset class, although all three active managers for developed international equity remain on the watch list for longer-term underperformance. Core plus and high yield managers added the most value to fixed income. As can be seen in the chart below, allocation impacts due to missing upturns in domestic and international equity markets through strategic reductions in 2009, as well as prior manager underperformance, continue to weigh down attributions for the longer periods.



Educational Retirement Board (ERB)

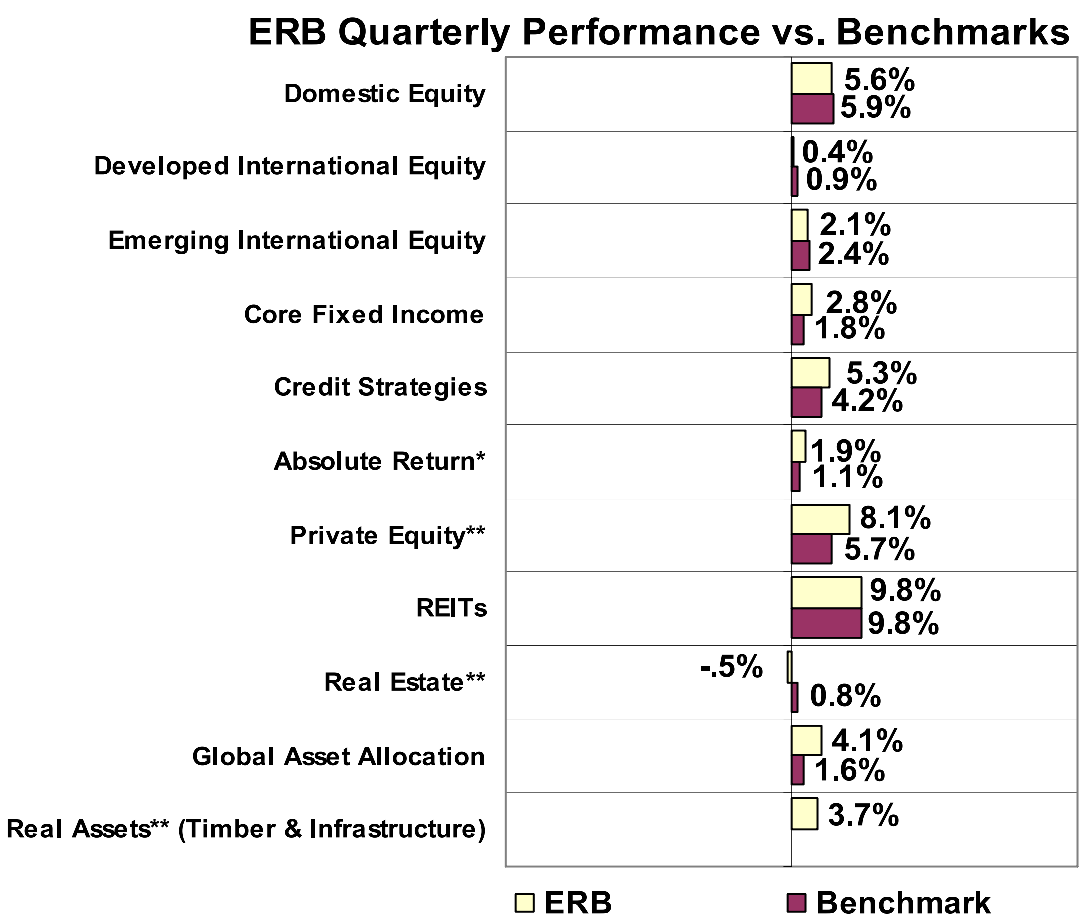
Fund Objective: ERB administers a defined benefit pension plan for public school and higher education employees. The fund is invested according to the "prudent investor rule" to ensure retirement benefits. The fund has an 8% long-term actuarial benchmark for funding purposes.



Fund Performance vs. Policy Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
40.40%	32.40%	9	5.30%	4.60%	11	2.80%	3.40%	89
Median Fund Performance		29.00%	Median Fund Performance		4.10%	Median Fund Performance		3.40%

*ERB also has an 8% actuarial benchmark for funding purposes.

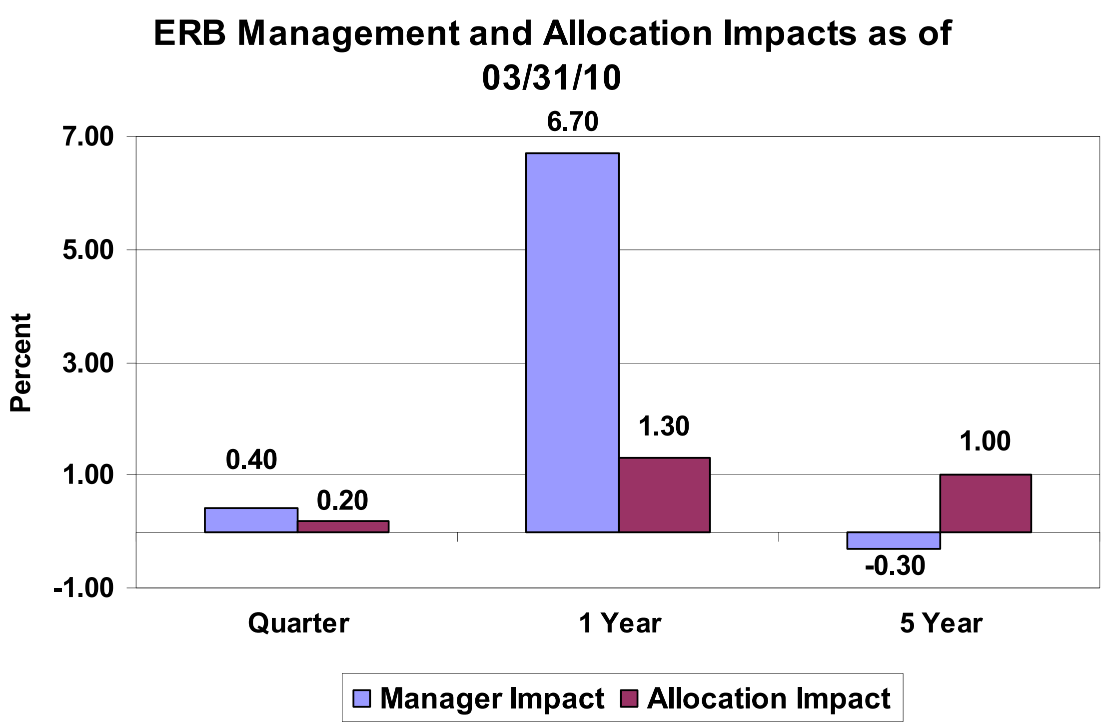


* Results Lagged One Month
** Results Lagged One Quarter

Overview: For the fourth consecutive quarter ERB outperformed its policy benchmark, this time by 60 bps. The fund slipped in its peer rankings, drawn down by the quarter's poorer relative showing of 28th quartile compared to the 5th quartile in December. This is most likely due primarily to the fund's lower commitment to domestic equities than comparable funds during a quarter of high returns. However, this allocation should offer more protection on the downside. The fund continues to surpass its one-year and five-year benchmarks, although the quarter's 10-year return remains less than 3 percent. Adding to this concern, the longer-term 15-year annualized return remains stubbornly below the 8 percent needed to meet pension obligations.

Asset class returns resumed a more normal pattern, with domestic equities outpacing fixed income. However, active domestic managers underperformed benchmarks. In particular, the -0.4 percent shortfall for large cap managers is leading ERB to consider indexing this mandate. ERB has terminated Rothschild, a small cap value manager, due to underperformance. The board recently completed its search for a replacement, turning over management of the smaller $90 million allocation to Lord Abbot. International managers also underperformed benchmarks in the aggregate, with only Alliance Bernstein showing a slight positive contribution. Fixed income sustained its positive performance, albeit at a more normal pace, with the both core and credit strategy managers contributing to the composite's 150 bps outperformance. Only one manager, Golden Tree, showed a below-expectation return. As with PERA, alternative asset classes helped ERB surpass its investment goals. Having the highest weights, the global asset allocation and hedge fund portfolio, in particular, added value.

Management and Allocation Impacts: Third quarter performance increases the value added from active management another 80 bps for the year, although the outstanding 670 bps remains insufficient to undo poor performance assimilated into the five-year computation. ERB staff retains some discretion in deviating from target weights within specified ranges; this impact has been slightly positive over each time period.



SPECIAL FOCUS: TARGET RATES OF INVESTMENT RETURNS

Both the SIC and state pension plans must achieve a certain long-term rate of investment return in order to meet obligations. This quarter's special focus summarizes the issues surrounding these assumptions as well as the consequences of changing it for each of the investing agencies. In general, some experts have begun to question whether the current rates are achievable at an acceptable level of risk. Another primary concern centers on whether the current rates for state pension funds—which are used to discount future obligations to produce current values—understate the true price of those liabilities. In this case, pension obligations may not only represent a hidden debt burden that is being pushed onto future generations to cover, they may balloon a state's total debt load when accounted for at fair market value. A recent New York Times article placed New Mexico third in a list that ranked states based on debt (including the pension liability valued at market) as a share of state GDP, with a ratio of just under 60 percent. Given the unfunded pension obligation as currently reported, that same debt ratio falls to about 20 percent.

<u>Permanent Funds</u>

Under the New Mexico Constitution the two largest permanent funds, LGPF and STPF, are required to make annual distributions to the general fund. These distributions are made as a percentage of each fund's average year ending market value for the preceding five calendar years. Table 1 shows these distributions by fiscal year. Due to a 2004 constitutional amendment, a new schedule for LGPF distributions was instituted from a flat 5 percent to as much as 5.8 percent. The distribution rate is then scheduled to gradually decrease back to its original percentage. The majority of LGPF distributions are made to the state general fund to support educational spending, while a smaller percentage go towards various higher education and corrections institutions throughout the state. All STPF distributions go entirely to the general fund.

Table 1

Permanent Fund Distribution Percentages by Fiscal Year

	LGPF*	STPF**
FY10	5.8%	4.7%
FY11	5.8%	4.7%
FY12	5.8%	4.7%
FY13	5.5%	4.7%
FY14	5.5%	4.7%
FY15	5.5%	4.7%
FY16	5.5%	4.7%
FY17	5.0%	4.7%

*Article XII, Section 7, NM Constitution

** Article VIII, Section 10, NM Constitution

Therefore the investment performance of both the LGPF and STPF have a direct fiscal impact upon the state's general fund. The impact is in fact so great that permanent fund distributions will represent nearly 12 percent, or more than $623 million, of overall recurring general fund revenue in FY10. Due to the distributions being made from the fund and other factors including inflation and statewide oil and gas production, both funds are forecast at an annual rate of return of 8.5 percent gross of fees. If this benchmark is not met, the funds will end up paying out more than they take in. As an example over the past three years both the LGPF and STPF have achieved annual returns of negative 1.0 percent and negative 2.1 percent respectively, and as a result both funds combined paid out approximately $2.7 billion more than they gained through investments. Such a mismatch ultimately resulted in fund market values declining by more than $1.9 billion during that time period.

Table 2
Ten Year LGPF and STPF General Fund Distribution Forecasts with Differing Annual Return Assumptions (millions)

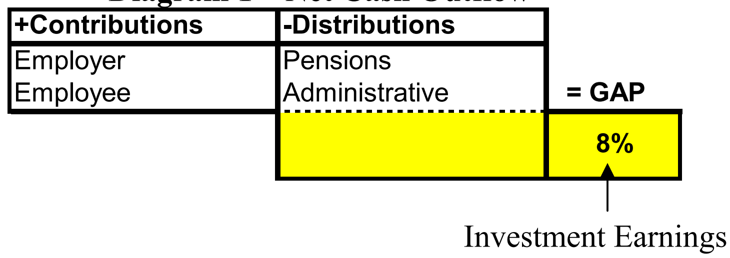
	LGPF			STPF		
	8.5%	7.5%	Difference	8.5%	7.5%	Difference
FY10	$ 436.5	$ 436.50	$ -	$ 187.07	$ 187.07	$ -
FY11	$ 445.2	$ 445.19	$ -	$ 184.57	$ 184.57	$ -
FY12	$ 453.9	$ 453.07	$ 0.9	$ 182.21	$ 181.88	$ 0.33
FY13	$ 433.2	$ 430.57	$ 2.6	$ 176.73	$ 175.69	$ 1.03
FY14	$ 433.8	$ 428.42	$ 5.4	$ 170.41	$ 168.27	$ 2.14
FY15	$ 466.0	$ 456.70	$ 9.3	$ 179.50	$ 175.83	$ 3.67
FY16	$ 492.5	$ 478.01	$ 14.5	$ 186.61	$ 180.93	$ 5.68
FY17	$ 472.4	$ 454.01	$ 18.4	$ 194.36	$ 186.50	$ 7.87
FY18	$ 497.78	$ 473.78	$ 24.0	$ 202.71	$ 192.49	$ 10.22
FY19	$ 524.02	$ 493.92	$ 30.1	$ 211.53	$ 198.79	$ 12.75
Total	$ 4,655.3	$ 4,550.2	$ 105.2	$ 1,875.7	$ 1,832.0	$ 43.7

Table 2 above shows the sensitivities of the permanent fund distributions to even a one percent change in annual investment return. Current general fund revenue forecasts use the benchmark rate of return of 8.5 percent for out year return assumptions. If that assumption were to be decreased to a 7.5 percent annual return general fund revenues as a result would be expected to decrease $148.9 million over the next ten years. It is therefore imperative that the funds' long-term performances not only be evaluated relative to policy benchmarks and peer performances, but relative to their distribution benchmark as well. Furthermore the distribution benchmark may warrant additional scrutiny as to its feasibility and appropriateness going forward.

<u>Pension Plans</u>

Both pension plans are mature pension plans, meaning cash outflows for administrative costs and benefits exceed inflows from contributions. Investment earnings must make up the difference, and both agencies assume assets will return 8 percent over the long run to close the gap. Anything less means the plan is not sustainable given current contributions and plan designs. This is why the 10-year annualized return of 3.6 percent for PERA and 2.8 percent for ERB are so concerning. Even with spectacular FY10 gains, losses from the two prior years are such that one must look as far back as 15 years to produce returns nearing the expected norm. More than any other period in the funds' history, expectations for portfolio performance going forward is of paramount importance.

Diagram 1 – Net Cash Outflow



Achieving 8 Percent. One key question becomes whether 8 percent is doable. Although this rate has been considered the standard for public plans for some time, pension plan sponsors have begun rethinking this rate in light of changing market conditions. CalPERS, for example, is considering decreasing its current rate of 7.75 percent set in 2003 to reflect "more realistic" returns. Recent forecasts reported to CalPERS for the 10-year return ranged from 7.03 percent to 7.7 percent[2], with consultants pointing to increasing market volatility for reducing expectations.

The Risk/Reward Tradeoff. A corollary concern, given the lowered expectations for traditional asset classes (such as stocks), is whether holding to an 8 percent return compels public funds to invest in riskier assets to chase excess return. Such alternative assets contributed to CalPERS' worse year on record although appear to have added value to New Mexico pension portfolios so far in FY10. A lingering concern, however, is whether risks associated with alternatives are fully divulged, appreciated or understood. ERB's investment in the Vanderbilt CDO may be a good example of an investment that promised above normal returns with little recognized or understood risk on the part of board members. Whether the risks were properly evaluated and represented is still a matter of debate.

True Value of Pension Obligations. Other critics of the 8 percent rate focus on the liability side of the balance sheet, suggesting that because the pension obligations are essentially "risk free," the risk free rate should be used to value those liabilities rather than an expected rate of investment return. The 8 percent includes a 4 percent anticipated rate of inflation plus a 4 percent "risk factor." Thus, a risk free rate of 4 percent is typically used in such analyses. However, pension costs skyrocket under this scenario, with total national unfunded obligations surging from an estimated $1 trillion to as high as $5 trillion[3].

In fact, valuing liabilities at the risk free rate renders public plans unsustainable beyond 2042 according to a recent study published by Kellogg School of Management at Northwestern University – even if plans make the 8 percent going forward. The study shows a theoretical New Mexico combined plan running dry by 2023.[4]

For many states, revaluing their obligations at the risk-free rate would immediate prompt higher contributions—which has been credited for the reluctance of pension officials (and their actuaries) to adopt a lower discount rate. Increased contributions spell higher taxes

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[2] *CalPERS Warned About Lower Investment Returns* by Dale Kasler, Sacramento Bee, May 18, 2010
[3] *The Day of Reckoning for State Pension Plans*, by Josh Rauh, March 22, 2010 (http:kelloggfinance.wordpress.com/author/jra455/)
[4] Ibid

or spending cuts in other areas of government—neither of which are particularly attractive options in today's economic climate. Some states have opted to increase employee contributions as part of a broad array of pension alternatives for tweaking plans to reduce costs to employers.

The controversy over reducing the discount rate to value plan liabilities may become moot within the next two years with a decision coming from the Governmental Accounting Standards Board (GASB) to use a different rate than the expected investment return. While GASB does not seem to be buying the argument that the risk-free rate should be used, it does seem to be seriously considering a proposal that suggests the proper discount rate is the employer's *borrowing* rate of interest since plan obligations represent debt to the public sponsor. The use of a governmental borrowing rate would inevitably involve a lower discount rate, substantially altering New Mexico pension plan unfunded obligations as Table 1 indicates using the UAAL for ERB. Such unfunded levels could jeopardize either plan overnight, simply from a change in the valuation methodology.

Table 3 – Unfunded Actuarial Accrued Liability (UAAL) Valued at Various Discount Rates (in billions)

Plan	Current* – 8%	7.75%	7.5%	7%	6%
ERB	\$4.5	\$4.9	\$5.4	\$6.3	\$8.5

* As of June 30, 2009. Even with FY10 gains that will most likely produce a reduced UAAL for the June 30, 2010 valuation, the table is useful in showing how the changing rates impact the UAAL calculation.

The Pension Equation. Over the long run, cash inflows must equal plan outflows for sustainability. The balance swings on the fulcrum of investment earnings. Earning less than 8 percent (or lowering the expected rate of return), holding all other factors constant, triggers increased contributions.

↑**C**ontributions + ↓**I**nvestment Earnings = **B**enefits + **E**xpenses

Valuing the pension plan liabilities at less than the 8 percent (whether due to lowering investment expectations as being done in California or due to using a different rate to value liabilities as is being considered by GASB) also implies increased contributions due to the jump in the cost of benefits.

↑**C**ontributions + **I**nvestment Earnings = ↑**B**enefits + **E**xpenses

Alternatively, the cost of providing a defined benefit plan can be reduced through plan redesign—a challenge that many states have been grappling since 2008 due to severe asset declines and continued revenue shortfalls.

Contributions + ↓**I**nvestment Earnings = ↓**B**enefits + **E**xpenses

Such pension reform, from reducing plan benefits for new hires to looking at more reasonable cost-of-living adjustments for retirees, have been met with varying degrees of acceptance by members. Unions have squared off in court in several states, from Colorado to New York, to fight changes they deem have "substantially altered the standards for retirement."

Where all stakeholders were involved in crafting legislation with the understanding that concessions were needed to preserve the defined benefits plan into perpetuity, such as in

New Hampshire, officials were able to reduce benefits even for typically "off-limits" vested members and retirees—who often enjoy statutory and constitutional protection—without a costly and lengthy legal backlash. This success bodes well for New Mexico, where a 25-member task force set up in 2009 (House Bill 573) includes union representation. This task force is scheduled to make recommendations for pension redesign this fall to facilitate any 2011 legislation.

This review is essential. Relying on an uncertain 8 percent target to make ends meet seems unfair to taxpayers who ultimately will have to help shore up plans to fulfill obligations in the event returns fall short, especially given new economic realities that suggest public pension plans provide an "asymmetrical payoff structure for public employees"[5] that remains dramatically out of sync with Social Security and Medicare age requirements. Adding the possibility that the true cost of that payoff structure has been systemically undervalued by discounting liabilities at the 8 percent investment factor only underscores the urgency with which policy makers need to seriously consider reducing the cost of New Mexico's pension plans. Even with spectacular gains made for FY10, the specter of contribution increases remains. Who will pay?

[5] *California's Pension Predicament*, by Girard Miller, GOVERNING, May 6, 2010